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Supreme Court of the United States

OCTOBER TERM, 1932.

No. 227

RICHARD REID ROGERS,

Petitioner,

against

GUARANTY TRUST COMPANY OF NEW YORK, JUNIUS PARKER, GEORGE W. HILL, C. F. NEILEY, A. C. MOWER, VINCENT RIGGIO, CHARLES A. PENN, J. B. HARVIE, R. J. BOYLAN, C. S. KEENE, J. K. FLETCHER and THE AMERICAN TOBACCO COMPANY,

Respondents.

RICHARD REID ROGERS,

Petitioner,

against

THE AMERICAN TOBACCO COMPANY and T. R. TAYLOR,

Respondents.

Consolidated Cause.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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INDEX

Petition

PAGE

Statement of Proceedings..... 1
Facts Involved..... 4
Reasons for Allowance of Writ..... 7

Brief

1. Failure of Plan to Conform to Statute under Which Issued..... 13
2. Waste in Sale of Stock..... 15
3. Unconstitutional Invasion of Pre-emptive Right. 19
4. Disposition of Corporate Assets Contrary to Charter..... 21
5. Alleged Failure to Comply with Rule 27..... 23
6. Sale of Stock for Services "to be Rendered".... 25
7. Duty to Disclose..... 25
8. Disqualification of Directors for Quorum..... 29
9. District Court Could Not Decline Jurisdiction in Its Discretion..... 30

Decisions Cited

Barrett v. Bloomfield, 64 N. J. Eq. 425, 441, 445.... 29
Barry v. Moeller, 68 N. J. Eq. 489..... 18
Black v. Del. & Rar. Canal Co., 24 N. J. Eq. 456....21, 22
Booth v. Beattie, 95 N. J. Eq. 776..... 17
Borg v. International Silver Co., 11 Fed. (2nd) 147, 151..... 19

Chicot v. Sherwood, 148 U. S. 529, 534..... 31
Colgate v. U. S. Leather Co., 75 N. J. Eq. 229.....21, 22

PAGE

Del. & Hud. v. Al. & Susquehanna R. R. Co., 213 U. S. 435, 440, 452 24
Dodge v. Woolsey, 18 How. 331, 341, 342 22

Einstein v. Raritan Woolen Mills, 74 N. J. Eq. 624, 629 21
Enright v. Hecksher, 240 Fed. 863, 872 30

General Investment Co. v. Am. Hide & Leather Co., 97 N. J. Eq. 214, 233, 235 27
German Ins. Co. v. Schwarzwaelder, 59 N. J. Eq. 589 21
Graussman v. Porto Rico Am. Tob. Co., 95 N. J. Eq. 155, 165 19

Hawes v. Oakland, 104 U. S. 450, 461 24
Hyde v. Stone, 20 How. 170, 175 ..... 10, 31

Itiso v. Met. Sav. & Loan Co., 68 N. J. L. 588, 590 .. 21

Kean v. Johnson, 9 N. J. Eq. 401 21
Kline v. Burke, 260 U. S. 226, 230 31

Loewenthal v. Rubber Co., 52 N. J. Eq. 440, 441 21

McClellan v. Carland, 217 U. S. 268, 281, 282 31
McKee v. United States, 8 Wall. 163, 167 20
Marr v. Marr, 73 N. J. Eq. 643, 650 17
McNab v. McNab & Harlin Mfg. Co., 62 Hun 18, 22; aff'd 133 N. Y. 687 29
Met. T. & T. Co. v. Domestic T. & T. Co., 44 N. J. Eq. 568, 573 30
Michoud v. Girod, 4 How. 188, 193 16
Miles v. Safe Deposit Co., 259 U. S. 247, 252 19
Mills v. The Central R. R., 41 N. J. Eq. 1 ..... 21, 22
Morganstern v. American Milling Co., 87 N. J. Eq. 358 19

PAGE

Newark Library Assn., Re, 64 N. J. L. 217, 219..... 21

Riker v. United Drug Co., 79 N. J. Eq. 580, 583.....21, 22
Rogers v. American Tobacco Co., Matter of, 143 Misc. Rep. 306, 309..... 3, 28

Scott v. Lorillard Co., 108 N. J. Eq. 153; aff'd 109 N. J. Eq. 417..... 21
Suydam v. Broadnax, 14 Pet. 67, 75.....10, 30

Twin Lick Oil Co. v. Marbury, 91 U. S. 587..... 18

United States v. Dunn, 268 U. S. 121, 131..... 17

Van Hook v. Somerville Mfg. Co., 5 N. J. Eq. 137, 169..... 30

Wall v. Utah Copper Co., 70 N. J. Eq. 17, 26.....19, 30
Wardell v. Railroad Co., 103 U. S. 651, 658..... 16
Way v. American Grease Co., 60 N. J. Eq. 263..... 19
Wilkinson v. Bauerle, 41 N. J. Eq. 635, 645..... 18
Williamson v. Missouri-Kansas Pipe Line Co., 56 Fed. (2nd) 503, 511.....10, 31

Zabriskie v. Hackensack Ry. Co., 18 N. J. Eq. 178, 191, 192..... 21

TEXTBOOKS CITED

Cook on Corporations, Sec. 653..... 18
Spellman on Directors, Sec. 232..... 18
Spellman on Corporate Directors, Sec. 179..... 30
Thompson on Corporations, Sec. 1257..... 29

Statutes, Rules and Constitutional Provisions

PAGE

United States Constitution, Art. 1, Sec. 10 (Contract Clause) 8

New Jersey Laws of 1920, Chap. 175—Smith on N. J. Corporation Law, p. 120 (Employees' Stock Subscriptions) 8, 13, 29

New Jersey General Corporation Act, Sec. 124, Laws of 1926, Chap. 318, Sec. 16—Smith, Vol. 2, p. 80 (Statute as to Pre-emption)..... 19

New Jersey General Corporation Act, Sec. 46, Laws of 1896, Chap. 185—Smith, Vol. 1, p. 228.....23, 25

New Jersey General Corporation Act, Laws of 1917, Chap. 195, Sec. 1—Smith, Vol. 1, p. 110..... 9

New Jersey General Corporation Act, Sec. 12, Laws of 1921—Smith, Vol. 1, p. 192..... 15

Equity Rule 27.....23, 24

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RICHARD REID ROGERS, Petitioner, against GUARANTY TRUST COMPANY OF NEW YORK, JUNIUS PARKER, GEORGE W. HILL, C. F. NEILEY, A. C. MOWER, VINCENT RIGGIO, CHARLES A. PENN, J. B. HARVIE, R. J. BOYLAN, C. S. KEENE, J. K. FLETCHER and THE AMERICAN TOBACCO COMPANY, Respondents.	Consolidated Cause.
RICHARD REID ROGERS, Petitioner, against THE AMERICAN TOBACCO COMPANY and T. R. TAYLOR, Respondents.	

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Statement.

This is a consolidation of two actions involving the validity of a so-called stock employees' plan of The Ameri-

can Tobacco Company, whereunder 312,968 shares of the company's common stock B were set aside for sale to employees; of which 56,712 shares have actually been sold, approximately three-fifths to the directors themselves and two-fifths to 521 other higher employees of the company and 5 others at $25 a share, when the stock had a current market value of $112 a share.

The first action was instituted in the Supreme Court of the County of New York by the petitioner, a citizen of New York, against The American Tobacco Company, T. R. Taylor and certain other directors of the Tobacco Company (fol. 3), to cancel the stock issued, to enjoin the issue of further stock, and to hold the directors responsible for attempting to carry out an alleged illegal transaction. This action was removed to the United States District Court for the Southern District of New York March 9, 1931, by the defendants The American Tobacco Company and T. R. Taylor, upon the ground that they were citizens of a different State from the plaintiff, and that the cause involved a separable controversy as to them (fol. 4). On April 6, 1931, this action, without objection, was discontinued as to all defendants except The American Tobacco Company and Taylor, the removing defendants (fol. 4). Further facts having been ascertained, including the participation of the Guaranty Trust Company of New York, which was found to be in actual possession of the stock sought to be cancelled, a second action was thereafter instituted by the petitioner in the Supreme Court of New York against Guaranty Trust Company of New York, Junius Parker, George W. Hill, C. F. Neiley, A. C. Mower, V. Riggio, Charles A. Penn, J. B. Harvie, R. J. Boylan, C. S. Keene, J. K. Fletcher and The American Tobacco Company (fol. 5). This action was removed to the United States District Court for the Southern District of New York by The American Tobacco Company and Charles A. Penn, April 25, 1931, upon the ground that they were citizens of different States from the plaintiff, and that the action involved a separable controversy as to them (fol. 6). The defendant Penn subsequently

died. On November 7, 1931, the District Court denied a motion to remand the second action to the State court, and entered an order consolidating the two actions (fols. 6, 7). The amount involved in each action exceeds $3,000.

Thereafter, a motion having been made by the plaintiff in the consolidated cause (1) to strike out the separate defenses in the answers of the appearing defendants on the ground of insufficiency; (2) for a decree on the pleadings for the relief prayed for in the amended complaint; and (3) in the alternative for an injunction *pendente lite* (fols. 10-18); the motion came on to be heard in the District Court December 24, 1931. On February 23, 1932, the District Court, after holding that "the matters raised in the amended complaints involve the internal management of a foreign corporation, to wit, a New Jersey corporation, and present questions for construction of New Jersey statutes," dismissed each of the bills of complaint "in the exercise of its discretion" without prejudice to the enforcement of the rights of the plaintiff, if any, in the courts of New Jersey (fol. 841). An appeal was taken by petitioner from this decree to the Circuit Court of Appeals for the Second Circuit. The appeal was argued therein May 2nd and 3rd, 1932, and on June 3rd the decree of the District Court was affirmed, Manton, P. J., and Chase, J., voting for affirmance and Swan, J., dissenting. Reference is made to the opinion of the District Court (Rec. p. 273), to the opinion of the majority of the Circuit Court of Appeals (p. 287), and to the dissenting opinion of Swan, J. (p. 297).

Because of the failure to obtain service of some of the defendants and the death of another, as appears above, the only parties now before the Court on this petition are Guaranty Trust Company of New York, Junius Parker, George W. Hill, Vincent Riggio, R. J. Boylan, T. R. Taylor and The American Tobacco Company.

The detailed facts set up in the amended complaint were ascertained as the result of an examination of the defendant's books, allowed by an order of the Supreme Court of New York County, *In re Rogers* v. *American Tobacco Co.*,

143 Misc. Rep. 306, affirmed by the Appellate Division of the Supreme Court, and appeal denied by the Court of Appeals of New York. Only the conclusions drawn by the pleader therefrom were denied by the answers. The case was therefore fully presented by the pleadings.

Facts.

The essential facts were as follows:

On June 25, 1930, the board of directors of The American Tobacco Company, all of whom were interested parties, passed resolutions (1) approving a reduction in the par value of the common and common stock B of the company from $50 to $25 per share, the issue of two shares of the new stock for one share of the old, and an increase in the authorized common stock to 2,000,000 shares and the authorized common stock B to 4,000,000 shares;* and (2) advising the approval by the stockholders of an employees' stock subscription plan pursuant to Chap. 175, L. 1920, State of New Jersey, Smith on N. J. Corp. Law (p. 120).

The material parts of this statute are as follows:

> "1. Any stock corporation formed under any law of this state may, upon such terms and conditions as may be determined in the manner hereinafter designated, provide and carry out a plan or plans for any or all of the following purposes:
>
> (a) The issue or the purchase and sale of its capital stock to any or all of its employees and those actively engaged in the conduct of its business or to trustees on their behalf and the payment for such stock in installments or at one time with or without the right to vote thereon pending payment therefor in full, and for aiding any such employees and said other persons in paying for such stock by contributions, compensation for services, or otherwise.
>
> * * * * * * *

* Note: The common stock and common stock B have the same financial rights; the common stock alone electing directors.

> 2. (b) Where the corporation has been formed without the said charter or by-law provisions [i. e., without appropriate charter provisions as here] the board of directors shall first formulate such plan or plans and pass a resolution declaring that in its opinion the adoption thereof is *advisable*, and shall call a meeting of the stockholders to take action thereon. * * *
>
> 3. Any plan adopted as aforesaid may be recalled, abolished, revised, amended, altered or changed in the same manner as is herein provided for its adoption; * * *
>
> 4. The privileges and powers conferred by this act shall be deemed to be in addition to and independent of any and all powers and authority conferred by any other law or laws, and not in restriction or limitation of any of the powers now permitted to corporations of this state. (L. 1920, C. 175.)"

The plan advised by the directors, and submitted for the stockholders' approval, provided (fol. 139):

That its purpose was to accord to such employees of The American Tobacco Company as may be selected as therein provided, by way of additional compensation for *services to be rendered* an opportunity to purchase shares of stock of the company. The manner of executing the plan was stated to be that the board of directors may at such times as it may determine by way of additional compensation for services to be rendered, offer and allot such stock for subscription to employees in such amounts to such persons, at such prices not less than the par value of the shares allotted payable in full or in instalments, "all as shall be determined with respect to each offering of stock to each individual pursuant to authority to be granted by the board of directors to the President for such purpose." It was further provided (fol. 145) that no employee shall be deemed ineligible to the benefits of the plan by reason of being also a director of the company. Finally, it was stated that the plan may be recalled or amended as provided by Sec. 3 of the law above cited.

At the stockholders' meeting called for July 28, 1930, more than two-thirds of the stockholders present voted approval of the foregoing resolutions. Petitioner's stock was voted against both resolutions; and a protest was read in his behalf which is set out in par. 10 of the complaint (fol. 43).

Under the resolutions thus adopted, 312,968 shares of common stock B were made available for sale to employees, including directors (fol. 47); every director, with one possible exception, being likewise an employee of the company (fol. 298).

Thereafter, on January 28, 1931, the directors of the company met in New York City and approved a sale at $25 a share of 56,712 shares of common stock B on the recommendation of the president as follows (fols. 68, 69):

	Shares
To the president himself	13,440
To other directors	19,330
To 521 other managers and higher employees	22,162
To others grouped by the company under the head "Miscellaneous" (fols. 66, 458) and not employees in the strict sense, as follows:	
One of the trustees	400
A member of the firm's counsel	980
The company's advertising agent	250
Two others	150
	56,712

No stock was allotted to any employee of lower rank than factory sub-assistant (fol. 298).

Every member of the board of directors present at this meeting participated in the allotment at $25 a share; each director present being recorded as voting upon the allotments to all other directors, but as not voting on his own particular allotment (fols. 70, 71).

On the day the stock was thus sold at $25 a share it had a market value of $112 a share (fol. 48).

The procedure adopted by the directors for carrying out the foregoing distribution of stock was as follows:

The stock was sold in the first instance for $25 a share cash to the Guaranty Trust Company, which was authorized as trustee to borrow from itself as an individual the requisite funds. The Guaranty Trust Company then allowed the individuals selected by the president of the Tobacco Company and its directors to subscribe for their several allotments at the same price, it being stated in the agreement that this was by the way of additional compensation for services to be rendered between the date of the agreement, January 31, 1931, and December 31, 1931 (fol. 329). Until December 31, 1931, no subscriber could take up his stock (fol. 337). Payments were to be made on the purchase price from time to time, corresponding to the amount and date of the regular quarterly dividend of $1.25 for each quarter (fol. 335). If any subscriber severed his connection with the company prior to December 31, 1931, it was left to the *trustees* to say whether he should have his allotment or not (fols. 343, 349).

The grounds upon which the invalidity of the foregoing transactions is predicated sufficiently appear from the following

Reasons for Allowance of the Writ.

1. The plan, inasmuch as it left everything to the president "pursuant to authority to be granted by the Board of Directors for such purpose," was not a definite or formulated plan, such as Chap. 175, L. of New Jersey, 1920, required.

The decision of the majority of the Circuit Court of Appeals to the contrary is believed to be in conflict with a statute of the State of New Jersey in an important matter of local law.

2. The stock was sold by directors, the larger part to themselves, at $87 a share less than its then market value. The majority of the Circuit Court of Appeals holds that this was not waste, upon the ground that "the selling price

of the stock on the market (which is always subject to fluctuation) will not justify an allegation of insufficient consideration amounting to fraud"; and that "the corporation received what those in charge of its internal affairs deemed to be sufficient as its par value" (p. 295).

This decision is believed to be untenable and in conflict with the weight of authority on an important matter of general law.

3. In construing Chap. 175, L. of 1920, as authorizing a sale of unissued stock in disregard of the stockholders' pre-emptive rights—a right recognized by the charter, common and statute law of New Jersey, and never taken away from petitioner by an amendment of the charter—the Circuit Court of Appeals gave effect to a State statute violating petitioner's charter contract, contrary to Article 1, Section 10, of the Federal Constitution.

This point was raised in the pleadings (fols. 58-60) and specifically presented by petitioner's briefs in the District Court and the Circuit Court of Appeals.

This decision is believed to be in conflict with the applicable decisions of New Jersey and of this Court, as well.

4. Under the charter of the company (fol. 161), the assets of the company can be used for two purposes only, (1) to put into a reserve fund to be applied to the acquisition of property, and (2) to declare dividends. In New Jersey the charter constitutes a contract of the shareholders *inter sese* which may not be changed by subsequent legislation, notwithstanding a reserved power to amend. The decision of the Circuit Court of Appeals gives effect to Chap. 175, L. 1920, in violation of this contract right, contrary to Article 1, Section 10, of the Federal Constitution.

This question was raised by petitioner's brief in the Circuit Court of Appeals.

5. The majority of the Circuit Court of Appeals held that the complaint should be dismissed for failure to com-

ply with Equity Rule 27 on the ground that plaintiff did not attempt to secure repeal of the plan by action of the shareholders.

This decision is believed to be contrary (1) to the express terms of Chap. 175, N. J. L. 1920, under which the plan was adopted; and (2) to the decisions of this Court on an important question of both local and general law.

6. The plan called for a sale of stock to employees for services "to be rendered." As the directors carried it out, the sale at $25 a share of stock worth $112 a share, was also said to be "by way of additional compensation for services to be rendered to the company to and including December 31, 1931 (fol. 329), i. e., from January 28th to December 31st, 1931. But Chap. 175, L. 1920, does not provide for a sale of stock to employees by way of compensation for services "to be rendered," and upon the contrary the general corporation law of New Jersey (L. 1917, Chap. 195, Sec. 1, Smith on N. J. Corporations, p. 110) provides only that a New Jersey corporation "may issue stock * * * for the amount it actually pays for *labor performed.*"

The decision of the Circuit Court of Appeals in upholding "services to be rendered" as a valid consideration in whole or in part for the stock issue is believed to be contrary to the New Jersey statutes on an important matter of local law.

7. The decision of the Circuit Court of Appeals in effect holds that in asking the stockholders' approval of the stock plan of 1930, the directors were under no duty to disclose the many other stock plans they had secretly put into effect without the stockholders' knowledge, from which they had largely profited, and the other benefits which the officers and employees were then receiving without the stockholders' knowledge.

This decision is believed contrary to the decisions of New Jersey, and in conflict with the weight of authority on an important question of general law.

8. The preliminary resolution of the directors, required under the statute, "advising the adoption of the plan," and the subsequent resolutions of the directors distributing the stock, largely to themselves, at so great an undervaluation, were invalid because not passed by a quorum of disinterested directors. The decision of the Circuit Court of Appeals disregarding this principle is believed untenable and in conflict with the weight of authority upon an important question of general law.

9. The judgment of the Circuit Court of Appeals, although the opinion considers the merits, affirms the judgment of the District Court declining to exercise an admitted jurisdiction in a case where jurisdiction is founded upon both diverse citizenship and the existence of a federal question. The decision of the majority of the Court in this regard is believed to be contrary to the rule laid down by this Court in *Suydam* v. *Broadnax*, 14 Pet. 67, 75; and *Hyde* v. *Stone*, 20 How. 170, 175, that "the courts of the United States are bound to proceed to judgment and afford redress to suitors before them in every case to which their jurisdiction extends. They cannot abdicate their authority or duty in any case in favor of another jurisdiction."

The decision, apart from this principle, is likewise in conflict with the decision of the Circuit Court of Appeals in the Seventh Circuit in the case of *Williamson* v. *Missouri-Kansas Pipe Line Co.*, rendered February 29, 1932, 56 Fed. (2nd) 503, where in a similar situation the Circuit Court of Appeals held that the District Court must take jurisdiction.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari issue to review the decree entered in the United States Circuit Court of Appeals for the Second Circuit in the above-mentioned consolidated action, entitled in said Court "Richard Reid Rogers, Plaintiff-Appellant, against Guaranty Trust Company of New York, Junius Parker, George W. Hill, C. F. Neiley, A. C. Mower, Vincent

Riggio, Charles A. Penn, J. B. Harvie, R. J. Boylan, C. S. Keene, J. K. Fletcher and The American Tobacco Company, Defendants-Appellees; Richard Reid Rogers, Plaintiff-Appellant, against The American Tobacco Company and T. R. Taylor, Defendants-Appellees; Consolidated Cause."

Respectfully submitted,

RICHARD REID ROGERS,
Petitioner.

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RICHARD REID ROGERS, Petitioner, against THE AMERICAN TOBACCO COMPANY and T. R. TAYLOR, Respondents.	

BRIEF IN SUPPORT OF APPLICATION FOR WRIT.

REASON 1.

Failure of Plan to Conform to Statute Under Which It Was Issued.

The law (Chap. 175, N. J. L. 1920) required the directors to formulate a plan and pass a resolution that its adoption was "advisable." It in terms provided for the

sale of stock by the company to "any or all of its employees." The words "any or all" in statutes of this character are generally used in a distributive sense, and it would seem that the legislative design was to allow *any* employee in good standing to become a stockholder of the company. The only definite term or condition fixed by the "plan," however, was that the stock should not be sold below par. Everything else, the choice of employees, the amounts allotted to each, the price, terms and conditions, by the express provisions of the "plan," were to be determined by the president pursuant to "authority to be granted" to him by the board of directors (fol. 121). Under this arrangement the president did not confine his selections entirely to employees of the company (fol. 66); and no rank and file employee was allowed to participate; whereas by adopting a formula based on fixed salary and contingent compensation (fol. 300)—in his own case amounting to $1,010,000 for 1930, and in the case of the vice-presidents running from $145,000 to $603,000 for the same year—he and the vice-presidents were enabled to obtain 30,125 shares out of a total of 56,712 (fols. 391, 392) at $87 a share less than the market value.

Under these circumstances, Swan, J., dissenting, was of the opinion that the plan was nothing more than a proposal; that it was not such a formulated plan as the statute contemplated. He says (p. 299):

> "It was a proposal that the stockholders abrogate the discretion which the statute vested in them to approve or disapprove a formulated plan declared by the directors to be advisable, and confer upon the directors and president complete discretion to determine and execute in the future, without further reference to the stockholders, any sort of allotment then thought desirable, provided only that the price to employees who were selected to share in it be not less than the par of the stock. The purpose of the statute was to let the stockholders know with some definiteness—'a formulated plan'—what the directors thought advisable, and to allow the stockholders to approve it, if at least two-thirds

> of them also deemed it advisable. This purpose is completely frustrated if it be sufficient to submit a plan which merely proposes that the directors shall be empowered to allot stock to employees on such terms as they may thereafter please. And the undesirability of transferring to the directors complete discretion as to what plan shall be formulated in the future is particularly apparent where, as here, they are entitled to benefit under the plan. It is aptly illustrated by what in fact happened."

He then refers to the large allotments received by the president and other directors above outlined, as illustrating the undesirabiltiy of transferring to the directors so complete a discretion. Nothing can be added to this argument.

REASON 2.

Waste in Sale of Stock.

The stock amounting to 56,712 shares, as has been stated in petition, was sold by the directors at $87 a share less than its then market value. Of this amount, the president received 13,440 shares, an aggregate profit of $1,169,000; the other directors 19,330 shares, an aggregate profit of $1,681,000. The remainder was sold to higher employees (Exhibit H, p. 131), with the exception of 1,780 shares sold to others ranked as "miscellaneous" and not believed to be employees in the sense of either statute or plan (fols. 66, 458).

This proceeding was justified by the majority of the Circuit Court of Appeals, as heretofore stated, upon the ground that "the selling price of stock on the market (which is always subject to fluctuation) will not justify an allegation of insufficient consideration amounting to fraud. The corporation received what those in charge of its internal affairs deemed to be sufficient as its par value"; that is to say, the directors, who alone in New Jersey have corporate management (Sec. 12, G. C. A.; Smith, p. 192).

It is true that the plan provided that the stock could not be sold for less than its par value; but it did not provide that it should be sold for less than its *actual* value. This not only seems evident from the plan itself; but was the construction placed upon it by the president of the company, when seeking proxies prior to the meeting. In response to a letter revoking the petitioner's proxy, the president wrote on July 1, 1930: "Subscriptions under the plan must be at a minimum but by no means or necessity a maximum price of $25.00 a share" (fol. 149).

The true rule as approved by text writers, the Courts of New Jersey and the decisions of this Court is exactly the contrary of that laid down by the Circuit Court of Appeals.

In *Wardell* v. *Railroad Co.*, 103 U. S. 651, 658, this Court said:

> "A person cannot be a purchaser of property and at the same time the agent of the vendor. The two positions impose different obligations, and their union would at once raise a conflict between interest and duty; and, 'constituted as humanity is, in the majority of cases duty would be overborne in the struggle.' *Marsh* v. *Whitmore*, 21 Wall. 178, 183. The law, therefore, will always condemn the transactions of a party on his own behalf when, in respect to the matter concerned, he is the agent of others, and will relieve against them whenever their enforcement is seasonably resisted. Directors of corporations, and all persons who stand in a fiduciary relation to other parties, and are clothed with power to act for them, are subject to this rule: they are not permitted to occupy a position which will conflict with the interest of parties they represent and are bound to protect. They cannot, as agents or trustees, enter into or authorize contracts on behalf of those for whom they are appointed to act, and then personally participate in the benefits."

The leading case in this Court no doubt is *Michoud* v. *Girod*, 4 How. 503, 556, where this Court laid down the general rule that a purchase by a trustee is fraudulent and void although a fair price be paid. Dealing with the

exception that a purchase by a trustee of his *cestui que trust,* provided that it is deliberately agreed or understood between them that the relation shall be dissolved, and that there is no fraud, concealment or advantage taken by the trustee, will be sustained in a court of equity, this Court went on to say:

> "But it is difficult to make out such a case, where the exception is taken, especially when there is any *inadequacy of price* or any inequality in the bargain."

And quite recently this Court in *United States* v. *Dunn,* 268 U. S. 121, 131, announced the doctrine where a trustee was interested in a sale:

> "It is not necessary in such a situation in order to establish a right for relief to show that the beneficiary was damaged by the fraudulent conduct of the trustee. It is sufficient to establish that the fiduciary has exercised his power of disposition for his own benefit, without more."

In New Jersey the rule is thus expressed:

> "The rule is that contracts made by a board of directors with one of their own number are, regardless of merits, voidable at the option of a dissatisfied stockholder, while such contracts sanctioned by a majority of the stockholders will be set aside by a court if it is disadvantageous to the minority stockholders. Equity will investigate." *Booth* v. *Beattie,* affirmed on opinion below, 95 N. J. Eq. 776.

In *Marr* v. *Marr,* 73 N. J. Eq. 643, 650, it was held by the Court of Errors and Appeals, Pitney, J., writing the opinion, that even where a director purchased corporate property at a sheriff's sale it was a controlling circumstance that the director purchased at *half* the value; and that the true rule is that "such a contract is voidable at the option of the cestui que trust exercised within a reasonable time."

In *Barry* v. *Moeller,* 68 N. J. Eq., at p. 489, it was said by Garrison, J.:

> "In cases where sales of property of the corporation are made to directors, the latter are charged with the full value of the property received, the contract price as fixed by the wrongdoer being completely disregarded."

This rule was declared to be the effect of the decision of the Court of Errors and Appeals in *Wilkinson* v. *Bauerle,* 41 N. J. Eq. 635, 645.

About the only exception to the foregoing rule recognized in this Court is where the trustee lends needed money to his *cestui que trust* and takes security, when he may purchase the property at a fair public sale, to protect himself. *Twin Lick Oil Co.* v. *Marbury,* 91 U. S. 587. But in that case the general doctrine was recognized as follows:

> "That a director of a joint-stock corporation occupies one of those fiduciary relations where his dealings with the subject-matter of his trust or agency, and with the beneficiary or party whose interest is confided to his care, is viewed with jealousy by the courts, and may be set aside on *slight* grounds, is a doctrine founded on the soundest morality, and which has received the clearest recognition in this court and in others."

The text writers are to the same purport: Spellman on Directors, Sec. 232; Cook on Corporations, Sec. 653.

To permit a rule to be established in the highest Federal Court in so important a commercial community as New York, to the effect that directors may sell stock to themselves or any others at one-fifth of its market value because stock has a fluctuating value, or because that is a matter of internal control, will imperil, it is believed, the rights of stockholders everywhere.

REASON 3.

The Unconstitutional Invasion of Petitioner's Pre-emptive Right to Subscribe to Unissued Stock by Giving Effect to a Later Legislative Act of the State of New Jersey (Chapter 175, Laws 1920).

The pre-emptive right of stockholders to subscribe to new stock was said by this Court in *Miles* v. *Safe Deposit Co.*, 259 U. S. 247, 252, to be so universally recognized as to have become "axiomatic in American corporation law."

It has always been fully recognized in New Jersey: *Way* v. *American Grease Co.*, 60 N. J. Eq. 263; *Wall* v. *Utah Copper Co.*, 70 N. J. Eq. 17; *Morganstern* v. *American Milling Co.*, 87 N. J. Eq. 358; *Graussman* v. *Porto Rico Am. Tob. Co.*, 95 N. J. Eq. 155, 165. In the latter case it was said: "the right of the present stockholders to have a first call upon the new stock cannot be defeated by any corrupt or other plan of the directors." In *Borg* v. *International Silver Co.*, 11 Fed. (2nd) 147, 151, opinion by Learned Hand, J., it was said: "To deprive them (the stockholders) of their right of pre-emption is to change their contract."

This rule, long recognized as a part of the common law of New Jersey, was crystallized into statute law by the Act of 1926, passed six years after the employees' aid act of 1920, and before the program of 1930 was initiated. This law (Smith, Vol. 2, p. 80) reads as follows:

> "Upon the issue of capital stock for cash, unless otherwise expressly provided in the certificate of incorporation, or in by-laws adopted by two-thirds in interest of each class of stockholders, every stockholder shall have a right (unless waived by him) according to the number of shares held by him to purchase his pro rata proportion of the stock to be issued, at such price (which may be in excess of the par value), within such time and on such terms as shall be fixed and determined by the board of di-

rectors; provided, that unless otherwise expressly provided in the certificate of incorporation, or by-laws adopted by two-thirds in interest of each class of stockholders, a holder of preferred or special stock entitled to limited preferential dividends and to a fixed sum upon any distribution of the assets of the corporation shall have and be entitled to exercise such pre-emptive rights only in case of the issue of stock of the same class held by him or of any class which has preference or priority as to assets or dividends over the class of stock held by him. In any such case the board of directors shall have power to determine what disposition shall be made of any stock to be issued and which shall not be subscribed for by stockholders. (G. C. A. Sec. 124, as added by L. 1926, C. 318, Sec. 16.)"

Inasmuch as neither by the charter nor any by-law had this pre-emptive right been surrendered by the stockholders, it could be taken away, if at all, only by an amendment of the charter approved by two-thirds of the stockholders of all classes outstanding. Under a familiar principle of statutory construction, that statutes must be reconciled (*McKee* v. *United States,* 8 Wall. 163, 167), the Act of 1920 should be confined to those corporations which either by the original charter, or possibly an amendment thereof, have cancelled this pre-emptive right.

The majority of the Circuit Court of Appeals attempted to meet this objection by the statement that the statutory right of pre-emption applied only for an issue and sale of the stock for "cash" (p. 295).

The stock, however, *was* issued for cash, if this be the important consideration. It was sold immediately to the Guaranty Trust Company, not even an employee, at $25 a share; and was reoffered to the directors and selected list of officers by the Guaranty Trust Company at the same price (fols. 62, 268). The Act of 1920, under which the plan was passed, does not provide for a sale for other than cash, although it authorizes the purchase price to be paid in instalments, and for company aid in paying for it.

There is even a further fundamental question of contract right involved. Under the decisions of New Jersey, the charter is a contract between the shareholders *inter sese* which may not be changed by subsequent legislation, notwithstanding a reserved power to amend (*Kean* v. *Johnson*, 9 Eq. 401; *Zabriskie* v. *Hackensack Ry. Co.*, 18 Eq. 178, 191, 192; *Black* v. *Del. & Rar. Canal Co.*, 24 Eq. 456; *Mills* v. *The Central R. R.*, 41 Eq. 1; *Loewenthal* v. *Rubber Co.*, 52 Eq. 440, 441; *German Ins. Co.* v. *Schwarzwaelder*, 59 Eq. 589; *Re Newark Library Assn.*, 64 N. J. L. 217, 219; *Einstein* v. *Raritan Woolen Mills*, 74 Eq. 624, 629; *Itiso* v. *Met. Sav. & Loan Co.*, 68 N. J. L. 588, 590; *Colgate* v. *U. S. Leather Co.*, 75 Eq. 229; *Riker* v. *United Drug Co.*, 79 Eq. 580, 583.

If this be so, the pre-emptive right, without the stockholders' consent, could not be taken away even under the Act of 1926; certainly not under the Act of 1920. This contract right seems to be recognized in the recent case of *Scott* v. *Lorillard Co.*, 108 N. J. Eq. 153, aff'd by the Court of Errors and Appeals, 109 N. J. Eq. 417, where the case proceeded upon the assumption that under the employees' stock plan in that case, it was essential that the stockholders waive their pre-emptive rights.

The question here presented involves a substantial constitutional right upon which it is respectfully submitted petitioner is entitled to be heard.

REASON 4.

Disposition of Corporate Assets Contrary to Charter.

The charter contained the following provision:

> "The directors of said merged corporation shall have the power to fix and determine from time to time and to vary the sum to be reserved, over and above its capital stock paid in, as a working capital, before declaring any dividends among its stockholders; and to direct and determine the use and disposition of any surplus or net profits or earnings,

> over and above the capital stock paid in. All sums so reserved may be applied from time to time to the acquisition of property as the directors shall from time to time determine" (fol. 160).

It is the petitioner's contention that under this provision the assets of the company could be applied only (1) to put in a reserve fund to acquire property as directed by the board, or (2) to payment of dividends.

The law of New Jersey is thus stated by the highest Court of the State in *Riker* v. *United Drug Co.*, 79 N. J. Eq. 580, 583:

> "Each stockholder of the company owns a share in its property and assets, and is entitled to have a proportionate share in its profits. They have invested their capital in it, and in it alone, and they are entitled to every dollar that it earns. This is the agreement of the stockholders among themselves. They each contract with the others that their money shall be employed for the purposes specified in the certificate of incorporation, and for no other purpose, and that the profits of the enterprise shall be ratably apportioned among them. In the absence of legislation permitting a variation of the provisions of this fundamental contract, by vote of a majority of the stockholders, no majority, however large, has the right to divert any part of the joint capital, however small, to any purpose not consistent with and growing out of this original, fundamental agreement" (citing *Black* v. *Del. & Raritan Canal Co.*, 24 N. J. Eq. 456, 463; *Mills* v. *Central Railroad Co.*, 41 Eq. 1; *Colgate* v. *U. S. Leather*, 75 Eq. 229).

The rule laid down in *Dodge* v. *Woolsey*, 18 How. 331, 341, 342, is to the same effect, where the following rule was approved:

> "It is a breach of trust towards a shareholder in a joint-stock incorporated company, established for certain definite purposes prescribed by its charter, if the funds or credit of the company are, without

> his consent, diverted from such purpose, though the misapplication be sanctioned by the votes of the majority; and, therefore, he may file a bill in equity against the company in his own behalf, to restrain the company by injunction from any such diversion or misapplication."

It can hardly be disputed that a sale of 56,712 shares of the company's capital stock at nearly $5,000,000 less than its then value is a dissipation of corporate assets. Inasmuch as the charter did not authorize such use of corporate property; and inasmuch as the authorities cited under Reason 3 show that the charter constitutes in New Jersey a contract between the shareholders *inter sese* not subject to alteration by a later legislative act, even under a reserved power to amend, it is submitted that the decision of the Circuit Court of Appeals allowing this to be done under cover of a later statute raises a fair question of invasion of constitutional rights upon which petitioner is entitled to be heard.

REASON 5.

Alleged Failure to Comply with Rule 27.

The majority opinion (p. 296) holds that petitioner is barred because of failure to combine with two other stockholders and call a meeting to cancel the employees' stock plan under Sec. 46 of the General Corporation Act of New Jersey (Chap. 185, L. 1896; Smith, p. 228), which provides that three or more stockholders of a New Jersey corporation may call a stockholders' meeting. To say nothing of the prohibitive cost and practical impossibility of petitioner's calling a meeting of stockholders of so large a company, it is submitted that this decision (1) disregards the actual situation here presented, and (2) violated the reason of Rule 27.

The dissenting opinion of Swan, J. (p. 301) deals fully with this question. The petitioner will, therefore,

only briefly summarize the reasons why under the facts of this case Rule 27 had no application.

First, the plan is claimed to be illegal. If so, there is nothing to repeal.

Second, if, however, the plan were legal, it was wastefully carried out, and in a manner contrary to the plan itself. Evidently in this latter aspect the plan does not require repeal.

Third, the plan itself requires any repeal or modification to be carried out under the provisions of Chap. 175, L. 1920. This act in turn requires the repeal to be effected in the same manner as the plan is originally passed, i. e., as a condition precedent to a stockholders' meeting the board of directors must first pass a resolution "advising" repeal. As the board of directors are all pecuniarily interested, have all participated in the benefits of the plan, have declined to sue on written demand, and have actively defended this action, relief through this channel is obviously impossible.

In *Hawes* v. *Oakland*, 104 U. S. 450, 461, out of which Rule 27 grew, an appeal to stockholders was said to be unnecessary where "it was not *reasonable* to require it." In the leading case of *Del. & Hud.* v. *Al. & Susquehanna R. R. Co.*, 213 U. S. 435, 440, 452, it was said the rule "is intended to have a *practical* operation, and to have that it must, as to its requirements, be given such play as to fit the conditions of different cases." The rule itself provides for an appeal to stockholders only where *"necessary."*

With the vast increase in the size of the corporations in this country it must be increasingly evident that an appeal to stockholders by a single stockholder to overthrow a seated management is a futile remedy (see op. Swan, J., p. 300). Such a requirement would effectually amount to a denial of justice in many cases, and give to Rule 27 that impractical application which this Court has condemned. In the case at bar, however, for the reasons stated Rule 27 had no application.

REASON 6.

The Sale of Stock to Employees for Services "to be Rendered."

It will be observed that the plan provides for a sale of stock to employees "by way of compensation for services to be rendered." In the agreement with the Guaranty Trust Company the sale of stock at $87 a share less than value, was also stated to be by way of "compensation for services to be rendered" for the remainder of the year (fol. 329). Evidently this was merely a legal device designed to import consideration into a transaction which was recognized as lacking of adequate consideration. It should be borne in mind that the president was already receiving $1,010,000 a year in salary and bonus; the senior vice-president $603,000 and the other vice-presidents from $459,000 to $555,000 (fols. 74-76); and it was altogether unlikely that this additional consideration was necessary to retain their services for a further period of eleven months.

Chap. 175, L. 1920, does not authorize stock to be sold to employees "by way of compensation for additional services to be rendered," as the plan itself and its execution endeavored to provide; and upon the other hand the General Corporation Act authorizes stock to be issued only "for labor performed" (G. C. A., Sec. 46; Smith, p. 228).

REASON 7.

Duty to Disclose.

In the official circular sent out with the notice of meeting to the stockholders soliciting their proxies to vote for the plan, the following statement was made by the president (fols. 114, 115):

> "I am certain that every stockholder will agree that it is to the company's interest that the or-

> ganization which has made possible the great success which the Company has enjoyed during the past few years should be given every encouragement to continue in the Company's employ. It is the purpose of this plan, conforming with the policies of many large business enterprises, to offer inducements by way of stock ownership in the Company to the men who have made that success possible, so that the Company and its stockholders will have the assurance of their continued services in carrying the business forward with maximum enthusiasm and efficiency."

From this language the stockholders would naturally infer that no other employees' stock plan had ever been put out by the company.

It appears, however, from the allegations of the complaint (par. 21, fols. 76-78, 95-98), not denied (fol. 587), that the directors had already put into effect without the knowledge or approval of the stockholders (compl., fol. 101; par. XIX, ans., fol. 591), between the years 1914 and October, 1929, numerous preferred stock plans and two common stock plans from which the employees as a whole and the directors had largely profited. Towards these various plans the company from the year 1914 as its contribution had set aside the sum of $240,000 a year (fols. 95, 96). The first preferred stock plans were confined to employees drawing salaries under $3,500 a year; but in the plans commencing in 1921, the salary limit was removed and the directors participated. There were also two common stock plans. In the first, put into effect in 1926, the company bought 21,500 shares of its old $50 par value stock, and sold it at cost chiefly to the directors, the president taking 8,000 shares and seven other officers, all of whom but one were directors, from 250 to 5,000 shares each. The company illegally was forced to guarantee the payment of the directors' notes issued to pay for this stock and negotiated with banks in New York City (fol. 77). In the second common stock plan, put into effect in 1929, 51,750 shares of the old stock (equivalent to twice as

many shares of the present stock), under the president's direction, without any previous authority from the board, were acquired by the company at $172 a share; and of this amount 46,500 shares were thereafter sold by the directors to themselves at that price at a time when, as their own resolution states (fol. 477), the stock was worth approximately $222 a share, or $50 a share more than they undertook to pay. Moreover, by a series of devious devices set up in sub-sections (e) and (f) of paragraph 21 of the complaint (fols. 87-101), $469,387.23 in 1929 and $917,625.96 in the year 1930 were misappropriated from the company's funds and applied in part payment of this stock.

In addition, the employees as a whole were receiving free medical services; and pensions costing the company $160,000 per annum (fols. 73, 74).

In addition, the president was receiving for the year 1930 a fixed salary of $168,000, and profit sharing for that year in the amount of $842,000 additional; the senior vice-president a fixed salary of $98,000, and profit sharing of $505,000; and the other vice-presidents fixed salaries of $50,000 each and profit sharings of from $409,000 to $505,000 (fols. 74-76). All these facts were unknown to petitioner and were not disclosed to the stockholders.

The suppression of these facts it is believed constituted unfair dealing with the stockholders going to the very root of the entire transaction and invalidating the stock plan *ab initio*. Certainly, the duty to have disclosed these facts is settled by definite authority; and no authority to the contrary has been discovered.

As said in *General Investment Co.* v. *Am. Hide & Leather Co.*, 97 N. J. Eq., 214, 235:

> "No one can say in advance what the effect would have been upon the sentiment of any stockholder had he known all that he was entitled to know."

The reason for the rule is thus stated (p. 233):

> "Any other rule would permit the most ruthless destruction of the rights of the stockholders. Adroit

> management could frequently prepare a scheme in such innocent guise that ordinary stockholders would not be put upon their guard unless the full discharge of their duties by directors or officers presented the objectionable information which might cause individual stockholders to more carefully scan the proposed plan, and seek competent advice. Furthermore, if the law is to remain a scientific co-ordinated body of principles, doctrines and rules, there is no reason that fiduciary agents, such as directors, should not be subjected to the underlying directions of the law pertaining to trustees, which they are *sub modo*. There is no better rule established than that 'a trustee is bound to communicate to his beneficiary any knowledge or information he may have obtained affecting the beneficiary's interests, so far as they are embraced in or depend upon the trust or confidential relations.' "

In this very case on the application for an examination of the books, the Supreme Court, Townley, J., said:

> "Another reason urged why the order should not be granted is the anomalous one that if a board of directors has done its duty as well as the present directors of The American Tobacco Company have performed theirs, a stockholder may not inquire into any plans they may have to benefit employees, considering themselves as employees. It is sufficient answer that the directors are nevertheless, regardless of the magnitude of their success, in the strictest fiduciary relation to the stockholders and must make a full disclosure of what profits they would make out of any scheme submitted by them for the approval of the company."
>
> *Matter of Rogers* v. *Amer. Tobacco Co.*, 143 Misc. Rep. 306, 309.

The opinion in the District Court (fol. 824) disposed of this point by the statement that "the plaintiff asks for no relief in this suit as to these matters." Actually the relief sought was the cancellation of the stock sale plan of 1930-1931 by reason of the deception thus practiced on the stockholders.

REASON 8.

Disqualification of Directors by Reason of Personal Interest to Constitute a Quorum for Passage of the Various Resolutions.

Chap. 175, L. 1920, required as a condition of submission to the stockholders a resolution of the board of directors declaring that in its opinion the adoption of the plan was "advisable."

In determining what was "advisable," the directors could not be influenced by their personal interests. That was an abuse of the authority given them, which Pitney, J., in *Barrett* v. *Bloomfield,* 64 N. J. Eq. 425, 441, 445, declared rendered the whole transaction void or voidable and subject to review by the courts. The directors were, therefore, disqualified to pass the original resolution advising the plan, inasmuch as they qualified themselves as beneficiaries thereunder and actually thereafter participated in the benefits.

Much less were they entitled to be counted for the purpose of making a quorum to pass the resolutions of January 28, 1931, distributing the stock at a price so greatly beneath its value. The fact that each director was recorded as not voting on his own particular allotment is of no significance when it appears that each director voted for the allotments to all others. In such a case it has been expressly held that voting "in rotation" has the same effect as voting directly (*McNab* v. *McNab & Harlin Mfg. Co.,* 62 Hun 18, 22; aff'd 133 N. Y. 687).

The law on this subject is settled by an overwhelming weight of authority, but the decision of the Circuit Court of Appeals completely disregards it.

In *Thompson on Corporations,* Sec. 1257, it is said that "the cases are practically unanimous upon the proposition that a director who is personally interested in a proposition, or as to any matter pending before the board, is disqualified from acting, *and cannot be counted in estimating the quorum.*"

In *Spellman on Corporate Directors,* Sec. 179, it is said that the rule is established "by an overwhelming weight of authority."

The doctrine is firmly established in New Jersey (*Van Hook* v. *Somerville Mfg. Co.,* 5 N. J. Eq. 137, 169; *Wall* v. *Utah Copper Co.,* 70 N. J. Eq. 17, 26; *Met. T. & T. Co.* v. *Domestic T. & T. Co.,* 44 N. J. Eq. 568, 573). In *Enright* v. *Hecksher,* 240 Fed. 863, 872 (C. C. A., 2nd Cir.), Rogers, J., writing the opinion, it was said:

> "A director, whose interest in a matter disqualifies him from voting upon a resolution concerning it, cannot, according to the better opinion, be counted when the vote is taken. A director so disqualified by personal interest loses, *pro hac vice,* his character as a director, and so cannot be counted. *That is the law of New Jersey.*"

REASON 9.

The District Court Could Not in Its Discretion Decline to Exercise an Admitted Jurisdiction.

The case is in the Federal Court by reason of diverse citizenship. There is also involved a federal question, viz.: the violation of petitioner's charter contract, by the construction placed by the Circuit Court of Appeals upon Chap. 175, N. J. L. of 1920. Under either aspect, the District Court could not decline jurisdiction. Although the Circuit Court of Appeals considered the case upon the merits, the order simply affirms the judgment below dismissing the case for jurisdictional reasons. As appears from the dissenting opinion of Swan, J., the jurisdictional question was thus necessarily involved (p. 301). The reasons why the District Court was bound to take jurisdiction were thus expressed in *Suydam* v. *Broadnax,* 14 Pet. 67, 75:

> "The 11th section of the act to establish the judicial courts of the United States carries out the

constitutional right of a citizen of one State to sue a citizen of another State in the circuit court of the United States, and gives the circuit court 'original cognizance, concurrent with the courts of the several states, of all suits of a civil nature, at common law, and in equity,' &c., &c. It was certainly intended to give to suitors, having a right to sue in the circuit court, remedies coextensive with these rights."

In *Hyde* v. *Stone,* 20 How. 170, 175, it was said that the federal courts are bound to afford redress to suitors in every case to which their jurisdiction extends.

"They cannot abdicate their authority or duty in any case in favor of another jurisdiction."

See likewise *Chicot* v. *Sherwood,* 148 U. S. 529, 534; *McClellan* v. *Carland,* 217 U. S. 268, 281, 282; *Kline* v. *Burke,* 260 U. S. 226, 230.

The decree of the District Court, affirmed by the Court of Appeals, was also in direct conflict with the decision of the Circuit Court of Appeals in the Seventh Circuit in the case of *Williamson* v. *Missouri-Kansas Pipe Line Co.* (decided Feb. 29, 1932), 56 Fed. (2nd) 503, 511.

The undisputed facts are that The American Tobacco Company is licensed to do business under the laws of New York, with its principal place of business in New York City, where its chief executives have their offices, where its board of directors customarily meets, and where its principal records are kept (fol. 30). Only one of the individual defendants is a resident of New Jersey (fols. 4, 5), and the stock sought to be cancelled is in the possession of the Guaranty Trust Company, a New York corporation, which could not be reached in New Jersey. The case is thus brought squarely under the decision in the *Williamson* case, which says:

"Bearing upon the question of expediency, convenience, and power to effectuate a decree in case

one should be rendered, each appellee has all of its books and records, its principal office, most of its business, many of its officers and directors, including its president, and part of its assets within this jurisdiction, and neither is doing any business in Delaware, or maintaining any office in that state except as is necessary under the Laws of Delaware to maintain its corporate existence. Each appellee is licensed to do business in Illinois, and has been served with process in this cause. Under the allegations of the bill we think that considerations of neither justice nor expediency point to the courts of Delaware as the appropriate tribunals to investigate and determine the charges made in the bill as against Parish & Co., and that the District Court has ample power to effectuate any judgment it may render, under the evidence, against Parish & Co. We think the trial court erred in declining to exercise jurisdiction."

Respectfully submitted,

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